



U.S. Department of Housing and Urban Development
Southwest District Office of Inspector General
1600 Throckmorton, Room 404
Post Office Box 2905
Fort Worth, Texas 76113-2905
(817) 978-9309 FAX (817) 978-9316
[HTTP://WWW.HUD.GOV/OIG/OIGINDEX.HTML](http://www.hud.gov/OIG/OIGINDEX.HTML)

October 23, 1997

98-FW-229-1802
1997-00866-01

MEMORANDUM FOR: Kenneth W. Beck
Acting Director, Office of Single Family Housing, 6LHS

FROM: D. Michael Beard
District Inspector General for Audit, 6AGA

SUBJECT: Congressional Inquiry
Section 203(k) of the National Housing Act
Office of Single Family Housing
Tulsa, Oklahoma

In response to a Congressional inquiry from the Honorable Steve Largent, we reviewed the purchase and rehabilitation under the 203(k) Loan Program of a house located in Tulsa, Oklahoma. The borrowers, Mr. Largent's constituents, complained that: (1) the lender and the realtor gave them no option as to the selection of the contractor and the inspector/consultant; therefore, lender and the realtor required the borrowers to use them; (2) the inspector passed the contractor's work as complete when it was not done, unacceptable, or only partially complete; (3) the lender improperly released funds to the contractor for incomplete work and from the contingency reserve; therefore, money is not available now to complete the work; (4) the contractor put a mechanic's and materialman's lien on the property; and (5) the consultant did not include work in the work scope to repair termite damage and the lender withheld a termite report from the buyer that showed active termites. Our objective was to determine the validity of the complaints and, if valid, the cause of the problems. We have provided a copy of this report to the complainant and the Honorable Steve Largent.

To achieve our objective, we reviewed applicable HUD regulations and policies; interviewed Office of Single Family Housing staff at the Tulsa HUD Field Office; interviewed the realtor, the lender, the consultant, the building contractor, and the borrowers; examined applicable agreements and other supporting documents; conducted a physical inspection of the house; and analyzed payments to the contractor.

Summary

The borrowers complained because of disagreements with the contractor and inspector/consultant on the quantity and quality of work completed. In our opinion, the borrower is partially at fault for the disagreements. However, the borrowers have not been well served under the 203(k) Program, and HUD should take an active interest in resolving their problems.

- We could not validate whether the realtor and the lender required the buyer to use the consultant and the contractor. Both realtor and lender personnel denied the allegation and no written evidence was noted.
- The remaining complaints we could partially validate. The inspector/consultant and the contractor overestimated completed work by \$1,512 as of July 11, 1996. Also, the lender inappropriately released \$1,178 in contingency funds for improvements that were not health and safety improvements. However, the lender released funds based on inspection reports that the contractor and inspector/consultant had signed. Further, the lender made the checks payable to both the borrower and the contractor. Thus, the checks required the borrower's endorsement. The contractor continued work subsequent to July 11, 1996, and requested another draw of funds. The borrower refused to approve this payment request document because of work perceived to be incomplete and unacceptable. Therefore, the contractor filed a mechanic's and materialman's lien on the property, causing complaint 4. Regarding complaint 5, we could not confirm the termite report was intentionally withheld from the borrowers. The termite report was not completed until just before the loan closing. We do not believe the consultant saw the termite report thus, she did not include all repairs of the termite damage in the work write-up.

During our review we noted the administration of the rehabilitation work was poor and the processing of the 203(k) flawed. For example, we do not believe HUD set the appropriate loan amount because the consultant did not include the cost of all items identified on the work write-up, did not include a value for the borrower's labor, and did not see the termite report. The borrower did not have a written contract with the contractor and building permits were not obtained. Finally, the borrower, the consultant/inspector, and the lender used rehabilitation funds for work other than that required to bring the property up to FHA standards. Most of the problems the borrower has encountered, can be attributed to the ineffectiveness of the HUD-approved consultant/inspector. We are providing details in the finding and recommendations for HUD action relating to this complaint. In our opinion, HUD and the lender should take an active part in helping the borrowers.

Within 60 days, please provide us the status on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; and (3) why action is not considered necessary. Please furnish us copies of any correspondence related to this report.

Background

Under the Section 203(k) Program, HUD insures the mortgages of houses that require at least \$5,000 in rehabilitation work. The program enables the borrower to get just one mortgage loan to finance both the acquisition and the rehabilitation of the property. The borrower generally obtains a loan to cover the sales price, closing costs, rehabilitation costs, and contingency reserve.

To provide funds for the rehabilitation, the mortgage amount is based on the projected value of the property with the work completed, taking into account the cost of the work. HUD-approved lenders are willing to lend the funds because HUD insures the mortgages. Upon loan closing, the borrower signs the rehabilitation loan agreement and the lender sets up a rehabilitation escrow account.

HUD requires borrowers to use a HUD-approved lender. To speed processing of the 203(k) loan, HUD encourages borrowers to use a HUD-approved independent consultant. The consultant conducts the initial home inspection and prepares the required architectural exhibits, the work write-up, and the cost estimate of the rehabilitation work.

After the consultant prepares the work write-up, HUD requires Section 203(k) borrowers to select the contractor(s) for the rehabilitation work. Borrowers have the option to either act as the contractor and hire subcontractors or to hire a contractor.

HUD requires borrowers to select HUD-approved fee inspectors to inspect the rehabilitation work as it progresses. The borrower may use the consultant to do the inspections. Following the receipt of each inspection report, the lender releases funds from the escrow account. HUD requires a 10 percent holdback for each release from the rehabilitation escrow account until after the final inspection and issuance of the Final Release Notice.

HUD requires the borrower to issue a change order before any changes are made to the construction plans. HUD requires the lender to approve change orders before the contractor does the work. If the borrower makes unauthorized changes, the lender is not obligated to pay for the changes out of the contingency reserve.

The borrowers, Brian and Rebecca Scott, purchased the house located at 1348 S. Erie Avenue, Tulsa, Oklahoma, under Section 203(k) of the National Housing Act and signed the \$50,300 mortgage note with Mercury Mortgage Company, Inc. on January 31, 1996. The mortgage funded the purchase of the house for \$31,012 and the rehabilitation escrow account for \$19,322 and other costs. HUD insured the mortgage for the entire amount. Mercury Mortgage Company, Inc. assigned the mortgage note to Colorado National Bank on February 5, 1996.

The Scotts hired MRB Enterprises as the contractor and Pat Butz as the consultant and inspector for the rehabilitation work on their Section 203(k) house. The borrower has not completed the rehabilitation work on the house because he fired MRB Enterprises and has not hired other contractors to complete the repair work.

FINDING

All Involved Parties Did Not Properly Administer the Rehabilitation Work

The rehabilitation of the property was not handled well by any of the parties involved. The contractor and the consultant overestimated the amount of work the contractor completed as of July 11, 1996, so the lender overpaid the contractor. The borrower endorsed checks for work without first assuring the work was acceptable. The borrower and the contractor did not execute a written contract specifying the work to be done by the contractor. Also, the consultant's work write-up did not include a cost estimate for work to be done by the borrower. The borrower and the contractor changed some of the work assignments so that the borrower did some work originally planned for the contractor and visa versa. The lender released funds before the borrower signed the required authorizations, although the lender made the checks payable to both the borrower and the contractor, requiring the borrower's endorsement. Also, the borrower and the contractor added work items to be paid out of the contingency reserve that were not health and safety items. Therefore, the amount of funds escrowed may not be enough to complete the rehabilitation and, the borrower is unhappy because of incomplete work or work perceived to be unacceptable. The borrower would not approve additional payments to the contractor, so the contractor filed a lien on the property.

Consultant's write-up not all-inclusive

The consultant's work write-up does not include all costs. The consultant submitted the write-up, the contractor's bid, and other supporting documents to the borrower, the lender, and HUD. HUD approved the work write-up. However, the write-up omits the material and labor costs of repairs that the contractor did not bid on; the value of the borrower's labor; and was completed without reference to the termite report. The lender relied on HUD's approval to signify the cost estimate was adequate.

Since the consultant omitted repair costs from the write-up, the total repair costs were not disclosed to the lender and HUD. As a result, the amount in the repair escrow may not be enough to totally repair the property.

Termite work not included in work write-up

Prior to closing, HUD ordered termite treatment on the house. The house had termite damage. The termite inspection report, dated January 24, 1996, disclosed termite damage that the consultant had not included in her December 1995 write-up. Both HUD and the lender received the termite report 6 days before the loan closing on the house. Neither HUD nor the lender notified the consultant, who did not see the termite report.

The consultant's engineer had seen the termite damage. His report said the borrower should put termite shields on pedestals added to the original foundation. However, the consultant did not require the borrower to add termite shields. The consultant did include some damage repair in her work

write-up; however, the termite report shows other items, such as dryrot damage, that is not in the write-up.

The lender overpaid the contractor \$1,512 through the third draw

Based on an inspection completed at our request on February 10, 1997, by a HUD housing specialist, we estimated the lender overpaid the contractor approximately \$1,512 from February 23, 1996, through the date of the third draw from the escrow, July 12, 1996, for incomplete and unapproved work. The total amount paid to the contractor through the third draw for work contained in the consultant's inspection report was \$10,411. This amount includes \$1,559 in change orders, less 10 percent holdback paid from the contingency reserve. This amount does not include a \$1,300 advance for carpet made on August 9, 1996, that the contractor installed since July 12, 1996. The lender depended on the HUD-approved consultant to report the proper percentage of completion on the approved rehabilitation work. However, based on the our inspection, we concluded the contractor and the consultant overestimated the rehabilitation percentage completed as reported on the third draw request dated July 11, 1996. The consultant did not provide an explanation but said she did not know what could have broken down since her last inspection on July 11, 1996.

To arrive at our estimate of overpayment as of July 12, 1996, we obtained an estimate of completion percentage from a HUD housing specialist. The estimate was based on the work in the latest work write-up. The HUD housing specialist completed the inspection on February 10, 1997. We then converted the completion percentage to a dollar value of completed work as of that date based on the dollar estimates in the work write-up. We adjusted this figure by the amount of work the contractor estimated she completed after July 12, 1996. We also adjusted the figure by the estimated cost the borrower incurred in doing some of the repairs. The estimate may not be precise and may be subject to a difference in judgment by construction professionals.

During our inspection, our inspector noted the consultant passed Item #17.a. (partition) as complete for the first draw. Our inspector indicated the contractor did not adequately repair the "T" wall and did not install a header when she removed a wall.

According to the borrower, he did not know what he was paying for because he did not see the draw requests until after he had endorsed the checks. After the lender received the consultant's inspection report and draw request for each inspection, the lender issued a check from the rehabilitation escrow account before obtaining the borrower's signature on the draw request. The lender assumed that the borrower accepted the repair work when he endorsed the checks.

Because the borrower did not sign the draw requests and change orders until after the checks were issued, the borrower might not have known the work items for which he was paying. This does not release the borrower from his responsibilities under the Self-Help Agreement and the 203(k) Borrower's Acknowledgement, although the borrower told us he did not read and understand these documents when he signed them.

The lender paid \$1,178 from contingency funds for items not required

During the second and third draws, the lender released contingency funds for non-health and non-safety related improvements of \$1,178. The lender officials said they released the funds based on inspections and draw requests presented by either the borrower, the consultant, or the contractor. The consultant told us the contractor and the borrower submitted the repairs to the lender on change orders with her inspection reports. She said it was the lender's responsibility to accept or reject change orders. She said change orders are supposed to be signed by the borrower, the contractor, and the lender. She said when she knows about change orders before she does a requested inspection, she inspects the work to see if the changes were completed. However, she does not always know about the changes before the inspection. The consultant said, in this case, the borrower and the builder initiated change orders that included items the borrower wanted instead of what was needed. These changes included the following items paid out of contingency funds.

Additional kitchen cabinets and ceramic tile	\$ 689
Security System	220
Additional den sheetrock and trim	<u>400</u>
Subtotal	\$1,309
Less 10% holdback	<u>131</u>
Total non-health/safety paid from contingency	<u>\$1,178</u>

The borrower had not completed certain health and safety repairs. In negotiating with the contractor, the borrower and the contractor left out some of the work contained in the consultant's work write-up, so the contractor's bid did not include all work recommended by the consultant. However, the borrower and the contractor planned to use \$1,200 of contingency funds for certain items.¹ The consultant adjusted her cost estimate to the contractor's estimate but left the work in the write-up. Attachment B contains a listing of work contained in the consultant's work write-up but left out of the contractor's bid. We consider certain items to be major requirements. Such items include cleaning and certifying that the hot water heater is safe and meets FHA and Code requirements. Also, replacing all defective or missing electrical receptacles should be required. Since the consultant omitted the cost of certain repairs in the work write-up, the lender and HUD had no practical way to identify the cost of work required to bring the property up to standards.

We believe it was likely that either the borrower, the contractor, or the consultant would, as the work progressed, discover deficiencies relating to health and safety not included in the repairs that needed to be completed. Except for the mechanical inspection, the borrower did not obtain any other

¹ The lender paid for a security system reported on a change order. The consultant did not include the security system in the work write-up; however, the borrower had initially planned to install a security system before negotiating with the contractor and omitting some repairs. The security system was one of the items the borrower and contractor planned to purchase out of contingency funds.

inspections as required by the City of Tulsa. The lender should not have released the contingency funds until it was certain funds would not be needed for health and safety items.

Disagreement between borrower and contractor

The borrower did not enter into a written contract or agreement with the contractor but used the work write-up prepared by the consultant as a guide for the work to be done. Without a written contract or agreement, it's not surprising that disagreements might occur. The contractor and the borrower made verbal agreements as the work progressed that involved adding work and substituting work the borrower agreed to do.

The borrower was going to do certain rehabilitation work to keep the rehabilitation costs down. The contractor's original estimate to do the required work was over \$26,000. Through deleting certain contractor work, agreeing to use lesser quality materials, and to do some of the work himself, the borrower was able to negotiate the contractor's estimate down to \$16,130. The contractor provided the estimate based on work planned for the contractor to complete. She omitted the labor costs on the following work items because she understood the borrower was to complete the work.

Item 3A	Install gutters and downspouts;
Item 9	Paint all exterior wood with latex;
Item 10	Caulk all window and door openings; caulk all dissimilar material intersections;
Item 14	Install weatherstripping on all exterior doors;
Item 16	Install door stops for interior doors; repair/replace all damaged/missing interior doors;
Item 22	Install rods and shelves in closets;
Item 26	Install towel bar, toilet paper holder, and shower rod;
Item 30a	Install insulation in the living room ceiling area; and
Item 34a	Remove all debris from the exterior and interior of the dwelling.

After the work started, the borrower and the contractor said they exchanged some work specified by the work write-up to be completed by the borrower and the contractor. Also, at the request of the borrower, the contractor did some additional work not called for by the work write-up. The contractor told us she applied funds saved from approved work to do unapproved work. Such unapproved work included:

1. Building an alcove for the refrigerator;
2. Building a shelf cabinet at a bathtub from the savings when the borrower removed the brick at the fireplace; and
3. Pouring cap on the back porch with cost savings from repairing the curb at the back of the garage.

In addition, the contractor did certain work for which she expected to receive payment in the fourth draw. This work included:

1. Removing door and widening the opening from the dining room to the den;
2. Replacing the trim in the den;
3. Installing three faucets in the bathroom;
4. Providing the electrical work for installation of ceiling fans;
5. Installing additional cabinets; and
6. Installing fireplace marble.

Further, according to the borrower, he purchased certain materials that the contractor was supposed to have provided.

We also discovered that the borrower and the contractor had not obtained the required City of Tulsa plumbing, electrical, and building permits. Except for the mechanical inspection, the borrower did not obtain any other inspections as required by the City of Tulsa.

The borrower and the contractor apparently had disagreements throughout the rehabilitation period. The borrower told us the contractor delayed the start of the work. But in some cases, the contractor and the borrower told us they were waiting for each other to complete certain rehabilitation work. Therefore, they both delayed the work. Also, the borrower said he could not do some of the work he agreed to do because the contractor did not provide the materials as agreed. He would not sign the fourth check or draw request when he suspected that he had overpaid the contractor. He refused to pay the contractor anymore funds and the contractor placed a \$5,368 lien on the house based on the amount of work for which she had not been paid. As a result, the borrower is in violation of the Rehabilitation Loan Agreement, which requires him to complete the repairs within 6 months following January 31, 1996.

On October 20, 1997, the borrower advised us that on July 15, 1997, his attorney requested the contractor to complete the work as agreed and the contractor refused. Therefore, the borrower and the contractor are still at an impasse.

RECOMMENDATIONS

We recommend HUD:

- 1A. Work directly with the lender to reconcile the disagreements between the borrower and the contractor so that the contractor releases the lien and all work required for the property to meet FHA standards can be completed.
- 1B. If the disagreements cannot be reconciled, require the lender to take action to protect the property rehabilitation and complete the rehabilitation as provided for in the Mortgage Rehabilitation Rider.
- 1C. Require the lender to improve its quality control procedures to assure that: (1) adequate and enforceable agreements exist between any future borrowers and contractors when contractors are expected to complete rehabilitation work; (2) borrowers are provided termite reports when completed; and (3) it issues no checks from escrow account funds without first obtaining: (a) the required permits issued by local authorities; (b) the required draw request documents with the required signature of the borrower; and (c) assurance that all health and safety work items are completed before work not required is paid for from contingency funds.
- 1D. Reexamine its approval of the consultant for the program. If allowed to continue, HUD must ensure she: (1) has adequate training; (2) enters into written agreements with any future 203(k) borrowers so each are aware of the consultant's responsibilities under the program; (3) adequately prepares any future work write-ups that clearly specify all required work to be done and includes all costs, regardless of whether the borrower intends to do the work; (4) examines termite reports; and (5) improves her draw inspections to arrive at completion percentage estimates that are closer to the actual completion percentage.

Work Included in Consultant's Work Write-up Without an Estimated Cost and Not Bid by Contractor²

Item 3b	Install splashblocks at all downspouts that discharge onto grass or dirt areas*;
Item 6b	Remove all stumps around the foundation area*;
Item 6c	Repair front porch; skim coat steps and porch*;
Item 6d	Remove garage service door;
Item 6f	Repair or replace all damaged wood deck*;
Item 9	Prepare exterior wood, hardboard, and sheet metal for painting; prime coat all new wood and bare spots*;
Item 15c	Remove service entry door to garage and install 2 X 4 wood framing, siding, and drywall*;
Item 16b	Ensure that all interior doors are operable and have the necessary hardware*;
Item 19c	Remove paneling and prepare walls and ceilings for painting;
Item 20	Replace or repair all damaged, split, and missing trim, baseboards, and door frames*;
Item 25	Grout ceramic tile to prevent water infiltration behind the ceramic tile;
Item 27c	Plumbing contractor to clean and certify hot water heater is safe and meets FHA and code requirements*;
Item 27d	Replace defective trip levers, missing shower head, etc.*;
Item 27e	Replace or repair outside hydrants*;
Item 28e	Replace all defective or missing receptacles; install electrical cover plates on all light switches and receptacles*;
Item 30b	Install vapor barrier full batt insulation in all exposed walls*;
Item 31a	Install new kitchen cabinets per owner's direction**;
Item 34b	Clean all windows, appliances, and plumbing fixtures; and
Item 34c	Clean all vinyl floor covering, ceramic tile, and vacuum all carpet.

² * denotes repairs that had not been completed as of February 10, 1997.

** denotes Borrower and Contractor initiated change order for this repair.

DISTRIBUTION

Secretary's Representative, 6AS
Oklahoma State Coordinator, 6IS
Tulsa Area Coordinator, 6LS
Comptroller, 6AF
Director, Housing, 6AH
Director, Accounting, 6AAF
Acting Director, Office of Single Family Housing, 6LHS, Tulsa (4)
Dwight P. Robinson, Deputy Secretary, SD (Room 10100)
Hal C. DeCell III, A/S for Congressional and Intergovernmental Relations, J (Room 10120)
Karen Hinton, Deputy A/S for Public Affairs, W (Room 10220)
Jon Cowan, Chief of Staff, S (Room 10000)
Robert Hickmott, Counselor to the Secretary, S (Room 10234)
Senior Advisor to the Secretary for Communication Policy, S (Room 10222)
Gail W. Laster, General Counsel, C (Room 10214)
Assistant Secretary for CPD, D (Room 7100)
Marilynn A. Davis, Assistant Secretary for Administration, A (Room 10110)
Nicolas P. Retsinas, Assistant Secretary for Housing, H (Room 9100)
Kevin Marchman, Acting A/S for Public & Indian Housing, P (Room 4100)
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
Housing ALO, HFM (Room 2108) (5)
Chief Financial Officer, F (Room 10164) (2)
Deputy Chief Financial Officer for Operations, FF (Room 10166) (2)
Director, Hsg. & Comm. Devel. Issues, **US GAO**, 441 G St. NW, Room 2474
Washington, DC 20548 **Attn: Judy England-Joseph**
Mr. Pete Sessions, Govt Reform & Oversight Comm., U.S. Congress,
House of Rep., Washington, D.C. 20515-4305
The Honorable Fred Thompson, Chairman, Comm. on Govt Affairs,
U.S. Senate, Washington, D.C. 20510-6250
The Honorable John Glenn, Ranking Member, Comm. on Govt Affairs,
U.S. Senate, Washington, D.C. 20510-6250
Cindy Sprunger, Subcomm. on Gen. Oversight & Invest., Room 212,
O'Neill House Ofc. Bldg., Washington, D.C. 20515
Inspector General
Auditee